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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Consolidated Appeal of:	)	**HEARING SUMMARY**
	)	**PERSONAL INCOME TAX APPEAL**
FELIX LIN AND BETTY LIN[1]	)	Case No. 477812
LINUS UPSON	)	Case No. 477856
RAFAEL WEINSTEIN	)	Case No. 477868

	Year(s)	Proposed Assessments[2]
Felix and Betty Lin	2003	$78,878
Linus Upson	2003	$67,595
Rafael Weinstein	2003	$40,846

Representing the Parties:

For Appellant: Sheila Joyce Kellerman, CPA

For Franchise Tax Board: Ann H. Hodges, Tax Counsel IV

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[1] Appellants Felix and Betty Lin and Appellant Linus Upson reside in San Mateo County. Appellant Rafael Weinstein resides in San Francisco.

[2] Respondent should be prepared to provide the amount of interest accrued as of the date of the hearing.

QUESTION: (1) Whether appellants are entitled to exclude 50 percent of the gain from the sale of AvantGo stock because the corporation met the requirements to be considered qualified small business stock.

HEARING SUMMARY

Background

Appellants Felix Lin (Lin), Linus Upson (Upson), and Rafael Weinstein (Weinstein) were founders of AvantGo, Inc. ("AvantGo" or "the corporation"). AvantGo was incorporated on June 30, 1997, in Delaware. In May 2000, AvantGo acquired Globalware Computing Inc., a company doing business in Chicago. In addition, AvantGo had salespeople located in other states and a foreign subsidiary which operated in London. AvantGo's initial public offering was on September 27, 2000, and, in 2003, Sybase, Inc. acquired all of AvantGo's outstanding shares. (Resp. Opening Br., Appendix C, p. 16.)[3]

In 2003, Lin, Upson, and Weinstein sold their stock in AvantGo, realizing a gain on the sale of the stock and each claimed a 50 percent exclusion of the gain under Revenue and Taxation Code (R&TC) section 18152.5 as gain from the sale of qualified small business stock. (App. Opening Br., p. 1.) Upon review on audit, respondent concluded that the AvantGo stock was not qualified small business stock (Resp. Opening Br., p. 10) and that appellants were not eligible for the 50 percent exclusion of gain under R&TC section 18152.5.

Respondent found that AvantGo failed to meet the 80 percent payroll test, one of the active business requirements of R&TC section 18152.5, during appellants' holding period of the corporation's stock. AvantGo had employees located in California, Chicago, and London. Respondent found that, during 2001 and 2002, less than 80 percent of the corporation's payroll was attributable to AvantGo's employees located in California. (Resp. Opening Br., p. 10, Appendix C, pp. 16-20.) As such, respondent concluded that AvantGo failed to meet the 80 percent payroll test during substantially all of appellants' holding period.

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[3] Respondent filed three opening briefs, one for each of the appellants. These opening briefs are identical except for respondent's references to information specific to the individual appellants (e.g., the acquisition date of the AvantGo stock, the gain amount on the sale of the stock, the amount excluded from gain, etc.). As such, any reference in this document to Respondent's Opening Brief, without a specific reference to a particular appellant, is a reference to all three of these briefs.

Appellants Felix and Betty Lin purchased AvantGo stock in 1997 and sold the stock in 1993. Appellants reported a gain on the sale of the stock of $1,987,285 and an exclusion of gain of $993,643. (Resp. Opening Br. (Lin), Appendix C, p. 16; Exhibit E, p. 4.) Based upon the audit results mentioned above, respondent issued a Notice of Proposed Assessment (NPA) on December 26, 2007. The NPA was protested and respondent subsequently issued a Notice of Action (NOA) on December 1, 2008, affirming the NPA. (App. Reply Br., Exhibit 1.) A timely appeal by appellants followed.

Appellant Linus Upson purchased AvantGo stock in 1997 and sold the stock in 2003. Appellant reported a gain on the sale of the stock of $1,842,549 and an exclusion of gain of $921,275. (Resp. Opening Br. (Upson), Appendix C, p. 16; Exhibit E, pp. 5-6.) Based upon the audit results mentioned above, respondent issued a NPA on July 18, 2007. The NPA was protested and respondent subsequently issued a NOA on December 1, 2008, affirming the NPA. (App. Reply Br., Exhibit 2.) A timely appeal by appellant followed.

Appellant Rafael Weinstein purchased AvantGo stock in 1997 and sold the stock in 2003. Appellant reported a gain on the sale of the stock of $1,059,875 and an exclusion of gain of $529,938. (Resp. Opening Br. (Weinstein), Appendix C, p. 16; Exhibit E, p. 5.) Based upon the audit results mentioned above, respondent issued a NPA on August 3, 2007. The NPA was protested and respondent subsequently issued a NOA on December 1, 2008, affirming the NPA. (App. Reply Br., Exhibit 3.) A timely appeal by appellant followed.

Overview

R&TC section 18152.5, subdivision (a), provides that, if certain conditions are met, a taxpayer may exclude 50 percent of the gain from the sale of qualified small business stock. As explained further below, there are many qualifications that must be met for stock to meet the requirements of the term "qualified small business stock." Among these requirements, subdivision (c)(2)(A) of R&TC section 18152.5 provides that "[s]tock in a corporation shall not be treated as qualified small business stock unless, during *substantially all* of the taxpayer's *holding period* for the stock, the corporation meets the *active business requirements* of subdivision (e) . . ." (Italics added.) Subdivision (e) of R&TC section 18152.5 provides that a corporation must meet an 80 percent asset test and an 80 percent payroll test. (The 80 percent asset test is not at issue in this matter.) Subdivision

(e)(9) of the statute provides that no more than 20 percent of a corporation's total payroll expense can be attributable to employment located outside of California. Or, conversely, 80 percent or more of a corporation's *total payroll expense* must be attributable to employment in California. As such, at issue here is whether AvantGo met this 80 percent payroll test, one of the active business requirements of R&TC section 18152.5, so the corporation's stock can be considered qualified small business stock.

Appellants' Contentions

Appellants assert that respondent erred in determining whether AvantGo met the 80 percent payroll test during appellants' holding period of the stock because respondent included severance pay incurred by the corporation in 2001 and 2002 as part of AvantGo's payroll expense. Appellants contend that AvantGo's payroll outside of California was attributable to severance pay. (App. Opening Br., p. 2.) Appellants assert that the requirement in R&TC section 18152.5 that no "more than 20 percent of the corporation's total payroll expense is attributable to employment" does not include AvantGo's payroll expense attributable to severance pay and expenses associated with the exercise of stock options upon termination because severance pay and other termination costs are not payroll expenses "attributable to employment." (App. Reply Br., p. 2, 8.)

Appellants contend that AvantGo was reducing its staff outside of its California headquarters in 2001 and 2002 and that severance pay skewed the corporation's payroll expense during that time. (App. Opening Br., p. 2.) Appellants state that, at the peak of AvantGo's growth in 2000, 86 percent of the corporation's 350 employees were located in California. However, after the completion of AvantGo's downsizing at the end of 2002, 92 percent of the corporation's 117 employees were located in California. (App. Supp. Br., p. 1.) Appellants contend that if severance pay and other termination costs associated with the downsizing are deducted from AvantGo's total payroll expense, as contemplated by R&TC section 18152.5, subdivision (e)(9), the corporation meets this active business requirement of the statute. (App. Reply Br., p. 2, 8.)

Appellants contend that in *Powell v. Calif. Department of Employment*, (1965) 63 Cal.2d 103, the California Supreme Court held that severance pay was not wages attributable to employment, such that claimants were entitled to receive unemployment benefits during the same period they were receiving severance pay. Appellants contend that the Employment Development Department's website

states that "severance pay is not wages for unemployment insurance purposes." In addition, appellants assert that respondent's reliance on *Social Security Board v. Nierotko*, (1946) 327 U.S. 358, is misplaced as the employee in that case was reinstated as an employee and the issue was back pay, not severance pay. Finally, appellants assert that in *Lisec v. United Airlines*, (1992) 10 Cal.App.4th 1500, the Court of Appeal found that payments made after termination were not made within the context of an ongoing employment relationship. Appellants argue that the Court of Appeal in *Lisec* found that damages paid for wrongful termination were not wages. Appellants further assert that the Court of Appeal distinguished *Lisec* as an employment termination case in contrast to *Nierotko*, where the employee was reinstated. (App. Opening Br., p. 2; App. Reply Br., pp. 8-9.)

Appellants contend that R&TC section 18152.5, subdivision (e)(9), states that "total payroll expenses" which are "attributable to employment" are to be considered, which requires an evaluation of whether severance pay and other termination costs are payroll expenses "attributable to employment." (App. Reply Br., p. 9.) Appellants contend that R&TC section 18152.5 does not state that "total payroll expenses" are to be considered. Appellants assert that respondent must give meaning to every word in the statute and must interpret the statute to promote the general purpose and policy of the law. (App. Supp. Br., p. 2.) Instead, appellants assert that, by adding the qualifying phrase "attributable to employment" to the term "payroll expenses," the Legislature defined the term "total payroll expenses" for purposes of the 80 percent payroll test as less than a corporation's total payroll expenses. As such, appellants assert that severance pay and termination costs are not a payroll expense attributable to employment and are properly excludable from total payroll expense for purposes of determining whether AvantGo met the 80 percent payroll test. (App. Reply Br., p. 9; App. Supp. Br., p. 2.)

Regarding the severance pay expended by AvantGo, appellants detail the corporation's employment between 2000 and 2002. At the end of 2000, AvantGo had 350 employees at the following locations (App. Reply Br., p. 2):

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Location	Employees	% of Total
California	300	86%
Chicago	5	1%
Other – U.S.	3	1%
United Kingdom	42	12%
Total	350	100%

AvantGo began to downsize in 2001, reducing its United Kingdom operation by 14 employees in 2001 and by 20 employees in 2002, leaving 8 employees at that location. In addition, the corporation eliminated 4 of its 5 Chicago employees and 183 California employees. By the end of 2002, appellants assert that AvantGo had 117 employees as follows (App. Reply Br., p. 3):

Location	Employees	% of Total
California	107	92%
Chicago	1	0.5%
Other – U.S.	1	0.5%
United Kingdom	8	7%
Total	117	100%

During 2001 and 2002 then, appellants contend that AvantGo was paid severance pay and incurred expenses associated with the exercise of stock options. For 2002, appellants assert that AvantGo incurred $2.4 million of severance and other costs as follows: $1.05 million for U.K. employees, $450,000 for Chicago employees, and $900,000 for California employees. Appellants state that, under United Kingdom law, terminated employees receive 22 weeks of severance pay, such that the severance paid by AvantGo for its U.K. employees was extremely high. Appellants contend that once AvantGo's 2002 payroll totals are adjusted to account for the $2.4 million in severance pay and other costs, 81 percent of the corporation's payroll is attributable to California for the year (i.e., $13,400,000

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of payroll attributable to California ÷ $16,600,000 in total payroll).[4] (App. Reply Br., pp. 10-11.) This is illustrated as follows (App. Supp. Br., p. 3):

Reporting Jurisdiction	Amount of Termination Costs	Termination Costs in California
California	$900,000	$900,000
Chicago	$450,000	---
United Kingdom	$1,050,000	---
Total	$2,400,000	$900,000
	Worldwide Payroll Expense	Payroll Expense in California
Sch. 100R	$19,000,000	$14,300,000
Total After Deducting Termination Costs	$16,600,000	$13,400,000
Calif. Payroll Ratio	---	81%

In addition, appellants disagree with respondent's assertion that appellants made a computational error. Appellants point out that, if AvantGo's termination costs were $2.2 million (or $2.4 million as appellants believe), the $9,000,000 of termination costs for California for 2002 as calculated by respondent do not make sense. (App. Supp. Br., p. 3.)

Moreover, appellants assert that AvantGo had total worldwide payroll expense of $19 million in 2000 when it employed 350 employees, but then had total worldwide payroll expense of $31 million in 2001 when it employed 142 fewer employees. As such, appellants assert that the 64 percent increase in total payroll expenses, coupled with the corresponding 60 percent decrease in the number of employees, represents AvantGo's payout of severance pay and other termination costs. Appellants contend that after the restructuring and consolidation by AvantGo, 90 percent of the corporation's payroll was attributable to employment in California in 2003. (App. Reply Br., pp. 10-11.)

[4] Appellants calculate the $13,400,000 of California payroll as follows: $14,300,000 total - $900,000 in severance costs attributable to California. Appellants calculate the $16,600,000 of total payroll as follows: $19,000,000 total - $2,400,000 in total severance costs.

Appellants ask, if AvantGo terminated its California employees, rather than its employees outside of California, necessitating high severance costs within California, would respondent now conclude that such costs should be included as part of AvantGo's total payroll expense so that the corporation could meet the 80 percent payroll test when no employees remained in California? Appellants assert that respondent would not make such an argument and that it is inconsistent for respondent to include such costs against appellants now to disqualify them under R&TC section 18152.5. (App. Reply Br., p. 12.)

Appellants also allege that AvantGo had payroll in California for 57.1 of the 67.4 months that appellants held the corporation's stock, such that AvantGo had 84.72 percent of its payroll in California during the entire holding period (App. Reply Br., pp. 3-4):

Holding Period	(A) Number of Months Holding the Stock	(B) Payroll Factor (from Sch. 100R)	(AxB) Number of Qualifying Months Based on Annual Factor
8/11/97 – 12/31/97	4.5	100%	4.5
1998	12	100%	12
1999	12	90.4205%	11
2000	12	85.8432%	10
2001	12	67.5386%	8
2002	12	75.1675%	9
1/1/03 – 2/25/03	2.9	90.2713%	2.6
Totals	67.4	---	57.1

Appellants state that respondent assumes there is no payroll attributable to California employment for the 24-month period of 2001 and 2002 based upon the Schedule 100R's filed for these years which show that AvantGo's California payroll was less than 80 percent of the corporation's total worldwide payroll for each of these years. Appellants argue that this is an unreasonable assumption and that, instead, AvantGo had payroll in excess of 80 percent in California for 17 of the 24 months during that time period (i.e., 8 months in 2001 + 9 months in 2002). Appellants assert that a more reasonable analysis assumes that AvantGo had payroll within California each year based upon the number of months that the

annual apportionment percentage dictates. (App. Reply Br., pp. 3-4; App. Supp. Br., pp. 5-6.)

Appellants also assert that respondent's reliance on AvantGo's Schedule 100R's for 2001 and 2002 is unreasonable. Appellants argue that Ernst & Young, which prepared AvantGo's returns, attached a disclosure statement to AvantGo's 2001 and 2002 returns indicating that the payroll amounts on the returns were estimates. Appellants contend the disclosure statements indicate that Ernst & Young had so little faith in the payroll amounts listed on the returns that the firm deemed it necessary to make the disclosure to protect itself from penalties. Nevertheless, appellants contend that respondent chose to rely on these estimated payroll amounts to deny appellants qualification under R&TC section 18152.5. (App. Reply Br., pp. 4-5.) Appellants further contend that there is no way of knowing whether the disclosure of estimated amounts relates only to AvantGo's Chicago location, and employees, or to AvantGo's California employees as well. Consequently, appellants contend that the payroll information on the returns (i.e., Schedule 100R's) is suspect and cannot be substantiated. (App. Supp. Br., p. 4.)

As to the term "substantially all," appellants contend that the term should be defined as 80 percent or more based upon the Board's decision in the *Appeal of Helen Cantor, et. al.*, 2002-SBE-008, Nov. 3, 2002, a Homeowners and Renters Property Tax Assistance (HRA) Law appeal and that the *Cantor* decision is dispositive in this matter. Appellants assert that the Board in *Cantor* relied upon California law interpreting the term "substantially all" and upon relevant statutes, statutes which concerned the holding of stock in other organizational contexts which defined the term "substantially all" as 80 percent or more. As such, appellants contend that the term should likewise be defined as 80 percent or more for purposes of R&TC section 18152.5. (App. Reply Br., p. 7; App. Supp. Br., p. 6.)

Appellants assert that respondent failed to attach any significance to the definition of "substantially all" in Internal Revenue Code (IRC) sections 351 through 368, and the supporting regulations, which were relied upon by the Board in the *Cantor* decision. These statutes are relevant as such statutes concern the holding of stock in various scenarios, which is the same subject matter as this appeal. Appellants further contend that respondent does not explain why the Board should ignore this decision and should instead conduct a new review of statutes and regulations to define this term. (App. Reply Br., pp. 6-7.)

Appellants also contend that respondent had no basis for relying upon a federal

empowerment zone statute for the following reasons: (1) a federal empowerment zone regulation enacted after the legislation defines the term "substantially all," not the statute; (2) given the breadth of the 1993 federal omnibus legislation, it is a stretch to claim that a regulation passed after the bill's enactment defines a term in the qualified small business stock portion of the same legislation; and (3) there are other federal empowerment zone statutes which define the term "substantially all" as something other than 85 percent or more, such as IRC section 1400N which defines the term as 80 percent or more. (App. Reply Br., p. 7.) In their supplemental brief, appellants assert that it is actually a federal empowerment regulation (Treas. Reg. Section 1.1400L(b)-1(c)(3)) which defines the term "substantially all" as 80 percent or more. In addition, appellants state that Sales and Use Tax Regulation 1595, subdivision (b)(2), defines the term "substantially all" as 80 percent or more. (App. Supp. Br., p. 5.)

Respondent's Contentions

Respondent asserts that, for the AvantGo stock to be considered qualified small business stock, 80 percent or more of AvantGo's payroll expense must be attributable to California for 85 percent of appellants' holding period of the stock. However, respondent states that AvantGo reported that less than 80 percent of its payroll expense was attributable to California during two years of appellants' holding period (i.e., 2001 and 2002). As such, respondent asserts that, for only 64 percent of appellants' holding period, 80 percent or more of AvantGo's payroll expense was attributable to California. As a result, respondent contends that, because 64 percent is not "substantially all" of appellants' holding period, the AvantGo stock cannot be considered qualified small business stock. (Resp. Opening Br., p. 10.)

According to respondent, appellant alleges that R&TC section 18152.5 contains a requirement that an employee has to be providing services at the moment the employee receives payment from the employer for such payments to be considered payroll expense. Respondent asserts that R&TC section 18152.5 contains no such requirement. Respondent argues that appellants' reliance on the statutory language "total payroll expense is attributable to employment" is an incorrect interpretation of the definition of payroll expense and, instead, the appropriate phrase to be considered is "attributable to employment located outside of California." Respondent asserts that this phrase does not

place a limit on what constitutes payroll expense under the statute. Respondent argues that appellants' assertion is without merit, as income tax statutes generally allow AvantGo to treat amounts paid to an employee as a payroll expense and to deduct such amounts against current income. (Resp. Opening Br., p. 11; Resp. Reply Br., p. 3.)

Respondent also contends that appellants' reliance on case law, for their argument that severance pay is not attributable to employment, is misplaced as the cases cited rely upon entirely different law. In *Powell*, for example, respondent asserts that the decision was based upon Unemployment Insurance Code statutes. In *Lisec*, respondent asserts the Court of Appeal did not hold that the payments made were not "attributable to employment," but that the employment relationship no longer existed. (Resp. Reply Br., pp. 3-4.)

Respondent asserts that AvantGo met the 80 percent payroll test for 64 percent of appellants' holding period as follows (Resp. Opening Br. (Lin), Appendix C, p. 20.):[5]

	Calif. Payroll %	Total Holding Period	Corp. Met the Requirement	Corp. Does Not Meet the Requirement
1997	100%	4.5	4.5	0
1998	100%	12	12	0
1999	90%	12	12	0
2000	86%	12	12	0
2001	68%	12	0	12
2002	75%	12	0	12
2003	90%	2.9	2.9	0
Total	---	67.4	43.4	24

Based upon this table, respondent focused on AvantGo's payroll attributable to California for 2001 and 2002. According to respondent, AvantGo reported the following payroll expenses on in 2001 and 2002 Schedule 100R's (Resp. Opening Br., Appendix C, p. 18):

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[5] The information used in this table is from Respondent's Opening Brief to the Lin Appeal. For the Upson Appeal, respondent concluded that AvantGo met the 80 percent payroll test for 64 percent of the holding period (i.e., 43 out of 67 months) (Resp. Opening Br. (Upson), Appendix C, p. 20). For the Weinstein Appeal, respondent concluded that AvantGo met the 80 percent payroll test for 65 percent of the holding period (i.e., 45 out of 69 months) (Resp. Opening Br. (Weinstein), Appendix C, p. 20).

Tax Year	California	All Locations (including California)	California Percentage
2001	$21,082,877	$31,216,029	68%
2002	$14,313,071	$19,041,560	75%

In reviewing AvantGo's 2002 Schedule 100R, respondent found that the federal wages reported on the return, as AvantGo's total wages for the year, failed to include the corporation's foreign wages for 2002. When respondent included foreign payroll of $1,942,972 as reported by AvantGo on its 2002 return, respondent found that only 72 percent of AvantGo's payroll for 2002 was attributable to California (i.e., $14,173,796 ÷ $19,572,191). (Resp. Opening Brief, pp. 8-9.)

Respondent argues that appellants made a computational error when attributing AvantGo's $2.4 million of severance pay and other costs for 2002 to AvantGo's California payroll total. Respondent asserts that appellants determined a percentage of terminated employees for California of 65 percent for 2002. Applying this percentage to California payroll of $14.3 million, respondent argues that appellants should have calculated termination costs associated with California of $9 million ($14.3 million x 65%), not $900,000.[6] As a result, respondent asserts that AvantGo's 2002 payroll, after the reduction for severance and other costs, should have been $5.3 million (i.e., $14.3 million - $9 million) and that the resulting payroll percentage attributable to California was only 62 percent (i.e., $5,300,000 ÷ $8,550,000). (Resp. Reply Br., pp. 4-5.)

Respondent states that appellants' alternative of calculating the number of months in which the 80 percent payroll test has been met (i.e., for 8 months in 2001 and 9 months in 2002) is unreasonable. Respondent argues the test is not that AvantGo had some amount of payroll in California, but that AvantGo had 80 percent or more of its payroll expense in California during the year. (Resp. Reply Br., p. 12.)

Respondent argues that its reliance on AvantGo's Schedule 100R's is reasonable, disputing appellants' allegation that such schedules were unreliable. Respondent states that, when

[6] Appeals Division staff (staff) notes that, in Appendix C of its Opening Brief, at p. 17, respondent states that AvantGo incurred $2.2 million of termination costs in 2002. Staff has reviewed AvantGo's September 30, 2002 Form 10-Q filed with the Securities and Exchange Commission (Resp. Opening Br., Exhibit H, p. 2) and confirmed this statement. As such, this amount of termination costs conflicts with respondent's assertion above.

AvantGo's returns were filed, Ernst & Young included a disclosure to avoid penalties that the payroll amounts on the returns reflected estimated amounts for AvantGo's subsidiary in Chicago. Respondent asserts that because AvantGo's California returns for these years were filed as combined returns, not consolidated returns, AvantGo's subsidiary in Chicago was taxed individually and the disclosure by Ernst & Young was limited to the reporting of information for that subsidiary only. As such, respondent asserts that Ernst & Young's estimated payroll amounts were limited to AvantGo's Chicago location which had a total of 5 employees. As appellants have not provided any information that the payroll information was inaccurate relating to AvantGo's other employees, respondent argues that its reliance on AvantGo's Schedule 100R's was reasonable. (Resp. Reply Br., pp. 12-13.)

Respondent asserts that the California statutory scheme for qualified small business stock was intended to mirror the federal qualified small business stock statutory scheme with the exception of limiting the incentives to investments in California businesses. Respondent further asserts that the Legislature enacted a stand-alone statute which mirrored federal law but with the additional requirements for California purposes. (Resp. Opening Br., pp. 1-2.)

Regarding the term "substantially all," respondent asserts that (1) the California and federal small business stock statutes do not contain a definition of the term and (2) there is no authority which specifically defines the term for purposes of these statutes. Respondent states that it searched the Revenue and Taxation Code and found the term "substantially all" used at least 14 times and defined in two statutes as "at least 85 percent" or "80 percent or more." Respondent also states that R&TC regulations defined the term as "80 percent or more." (See Cal. Code Regs., tit. 18, § 1595, subd. (b)(2).) (Resp. Opening Br., pp. 3-4; Resp. Opening Br., Appendix B, p. 15.) Respondent also asserts that it searched the Internal Revenue Code and found the term "substantially all" used but not defined in at least 106 statutes. Respondent states, however, that the term was defined in 13 of 18 Treasury Regulations as "85 percent or more." (Resp. Opening Br., p. 4 and Appendix A, pp. 13-14.)

Respondent also asserts that the federal small business stock statute and a federal empowerment zone statute were passed at the same time, govern the same subject matter, and are in the same chapter of the federal act (i.e., Chapter 1 of the Revenue Provisions of the Revenue Reconciliation Bill of 1993), and have similar purposes and goals (to stimulate investment and to create jobs). (Resp.

Opening Br., pp. 4-5.) Respondent contends that the applicable regulation (Treas. Reg. Section 1.1394-1(l)), pertaining to "qualified zone property," defines "substantially all" as 85 percent.[7] (Resp. Reply Br., pp. 6-7.) Respondent contends that because of these similarities, and the Legislature's intent that California should follow federal small business stock rules, except where there were clear differences, the term "substantially all" should likewise be defined as 85 percent for purposes of the small business stock statute. (Resp. Opening Br., pp. 4-5.)

Respondent further contends that appellants' reliance on a federal regulation, relating to IRC section 1400N, for the proposition that "substantially all" means 80 percent or more is misplaced. Respondent argues that it was unable to find an "empowerment zone" regulation which contained such a definition, but that appellants were instead merely referencing a 2006 Internal Revenue Service notice. Respondent argues that this notice was issued 13 years after the enactment of the federal qualified small stock statute, while the applicable Treasury Regulation, with the 85 percent language, was enacted less than 3 years after the federal legislation. (Resp. Reply Br., pp. 8-9.)

Respondent also asserts that the Legislature intended for California to follow the federal statute unless there were clear differences, such that "substantially all" should be defined as 85 percent. Respondent argues that to define "substantially all" as less than 85 percent could mean that a corporation could have no payroll in California for an entire year and still qualify under the statute, which is not a result the Legislature would have intended.[8] (Resp. Reply Br., p. 9.)

Respondent contends that its position is also supported by the Board's decision in the *Appeal of Helen Cantor, supra*. Although the Board in that appeal addressed the definition of the term "substantially equivalent" and concluded that the term could reasonably be defined as at least 80 percent, respondent contends that the Board relied upon various statutes and regulations which support respondent's conclusion that the term "substantially all" is at least 85 percent. (Resp. Opening Br.,

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[7] Staff notes that respondent stated in its opening brief that the federal empowerment zone statute (Int.Rev. Code, § 1397D) defined the term "substantially all" as 85 percent.

[8] Respondent provides the following example: A taxpayer held stock for the minimum of five years and for the first four years of the five-year holding period, the corporation had 100 percent of its payroll attributable to California. In the fifth year, however, the corporation had none of its payroll attributable to California. Under such a scenario, the taxpayer would meet an 80 percent holding period requirement, as proposed by appellants, as the corporation met the 80 percent payroll test in 4 out of the 5 years. (Resp. Opening Br., p. 5, fn. 7.)

pp. 5-7.)

In its reply brief, however, respondent concludes that the Board's decision in *Cantor* is not applicable here as the Board in that matter defined the term "substantially equivalent" rather than "substantially all," such that the reasoning and analysis in that opinion do not apply to the qualified small business statute. To illustrate this point, respondent states that the Board in *Cantor* applies IRC sections 351 through 368 to reach its conclusion, statutes which concern corporate organizations and reorganizations and the effects of such transfers on shareholders and corporations. (Resp. Reply Br., p. 11.)

Based upon the above, respondent concludes that the AvantGo stock is not qualified small business stock, such that appellants' gain from the sale of this stock is not eligible for the 50 percent exclusion under R&TC section 18152.5.

Applicable Law

R&TC section 18152.5 provides that, under certain circumstances, a taxpayer may exclude 50 percent of the gain from the sale of qualified small business stock. (Rev. & Tax. Code, § 18152.5, subd. (a).) Although IRC section 1202 also provides for a 50 percent exclusion of the gain from the sale of qualified small business stock, the Legislature specifically provided that this statute is not applicable to determining California income.[9] (Rev. & Tax. Code, 18152, subd. (a).)

Qualification for the exclusion from gain under R&TC section 18152.5 includes meeting a variety of requirements. In order to be entitled to exclude gain from the sale of stock under R&TC section 18152.5, the stock must be considered "qualified small business stock." Pertinent here are various requirements under subdivisions (c), (d), and (e) of the statute. The term "qualified small business stock" is considered any stock in a C corporation which is originally issued after April 10, 1993, if (1) as of the date of issuance, the corporation is a qualified small business, and (2) the stock is acquired by the taxpayer at the time of its original issuance in exchange for money, property (not including stock), or as compensation for services. (Rev. & Tax. Code, 18152.5, subd. (c)(1).)

[9] Subdivision (l) of R&TC section 18152.5 also provides that:
"It is the intent of the Legislature that, in construing this section, any regulations that may be promulgated by the Secretary of Treasury under Section 1202(k) of the Internal Revenue Code shall apply to the extent that those regulations do not conflict with this section or with any regulations that may be promulgated by the Franchise Tax Board."

In addition to these criteria, subdivision (c) further defines the term "qualified small business stock" by providing that stock in a corporation will not be treated as qualified small business stock unless, during substantially all of a taxpayer's holding period of the stock, the corporation meets the active business requirements delineated in subdivision (e) of the statute. (Rev. & Tax. Code, 18152.5, subd. (c)(2)(A).) Under subdivision (e), at least 80 percent (by value) of a corporation's assets must be used in the active conduct of qualified businesses in California (Rev. & Tax. Code, 18152.5, subd. (e)(1)(A).) In addition, no more than 20 percent of a corporation's total payroll expense can be attributable to employment located outside of California. (Rev. & Tax. Code, 18152.5, subd. (e)(9).) (Or, in other words, 80 percent or more of a corporation's total payroll expense must be attributable to employment in California.) As such, a corporation meets the active business requirements of subdivision (c)(2)(A) of R&TC section 18152.5 if, during substantially all of a taxpayer's holding period of the stock, the corporation meets the 80 percent asset test (Rev. & Tax. Code, 18152.5, subd. (e)(1)(A)) and the 80 percent payroll test (Rev. & Tax. Code, 18152.5, subd. (e)(9)).

Regarding the inclusion of severance pay and other costs as part of AvantGo's total payroll expense, and the issue of statutory construction, in order to determine the Legislature's intent so as "to effectuate the purpose of the law," one must "first look to the words of the statute themselves, giving to the language its usual, ordinary import and according significance, if possible, to every word, phrase and sentence . . . . A construction making some words surplusage is to be avoided." In addition, statutory language "must be construed in context, keeping in mind the statutory purpose, and statutes or statutory sections relating to the same subject must be harmonized, both internally and with each other, to the extent possible. Where uncertainty exists consideration should be given to the consequences that will flow from a particular interpretation." (*Dyna-Med, Inc. v. Fair Employment & Housing Com.* (1987) 43 Cal.3d 1379, 1386-87, citations omitted.)

Finally, neither R&TC section 18152.5 nor IRC section 1202 contain a definition of the term "substantially all." Moreover, there is no authority under either California or federal law which has defined this term for purposes of the small business stock statutes.

STAFF COMMENTS

Appellants assert that severance pay and other termination costs are not payroll expenses

"attributable to employment" and, as such, should not be considered for purposes of determining whether AvantGo met the 80 percent payroll test in 2001 and 2002. As such, the parties should be prepared to address the statutory construction of R&TC section 18152.5, subdivision (e)(9), in relation to the use of the phrase "attributable to employment" in that subdivision of the statute.

Appellants have asserted an alternate approach for determining whether AvantGo met the 80 percent payroll test for 2001 and 2002 and proffered that 8 months for 2001 and 9 months for 2002 should be counted towards meeting the 80 percent payroll test in these years. As staff understands it, appellants' proposed interpretation of R&TC section 18152.5, subdivision (e)(9), can be explained with the following example. A corporation has $100,000 of payroll each month for an entire calendar year, for total payroll expense of $1,200,000. For the first 6 months of the year, 100 percent of the payroll, or $100,000 per month, is attributable to California. For the second 6 months of the year, 50 percent of the payroll, or $50,000 per month, is attributable to California. Respondent would conclude that the corporation met the 80 percent payroll test for 6 months of that year. Appellants would conclude that the corporation met the 80 percent payroll test for 9 months of that year. (Appellants would assert that, because 75 percent of the corporation's payroll for the year (i.e., ($100,000 x 6 months) + ($50,000 x 6 months) = $900,000; $900,000 ÷ $1,200,000 = 75%) was attributable to California, the corporation met the 80 percent payroll test for 9 months of the year (i.e., 12 months x 75%).)

As such, the parties should be prepared to discuss how the number of qualifying months within a holding period, such as a year, are determined for purposes of meeting the 80 percent payroll test requirement for California. In other words, the parties should be prepared to discuss (1) whether the payroll comparison is made on a monthly or annual basis, and (2) whether it is appropriate to apply the apportionment percentage applicable to California for a year to determine the number of qualifying months of California payroll.

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